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 Debt Acquisition Company of America V

# UNITED STATES BANKRUPTCY COURT

District of Nevada

In re	)	Case No. BK-S-06-10725 LBR
USA COMMERCIAL MORTGAGE COMPANY	)	
Debtor.	)	MEMORANDUM OF POINTS AND
	)	AUTHORITIES IN OPPOSITION TO
In re	)	DEBTOR'S MOTION FOR APPROVAL
USA CAPITAL REALTY ADVISORS, LLC	)	OF PROCEDURES REGARDING
Debtor.	)	ASSIGNMENTS OF LENDERS' DIRECT
	)	INTERESTS IN LOANS
	)	(AFFECTS USA COMMERCIAL
	)	MORTGAGE)
In re	)	
USA CAPITAL DIVERSIFIED TRUST FUND, LLC	)	DATE: December 19, 2006
Debtor.	)	
	)	TIME: 10:00 a.m.
In re	)	
USA CAPITAL FIRST TRUST DEED FUND, LLC	)	
Debtor.	)	
In re	)	
USA COMMERCIAL MORTGAGE COMPANY	)	
Debtor.	)	
Affects:	)	
<input type="checkbox"/> All Debtors	)	
<input checked="" type="checkbox"/> USA Commercial Mortgage Company	)	
<input type="checkbox"/> USA Capital Realty Advisors, LLC	)	
<input checked="" type="checkbox"/> USA Capital Diversified Trust Fund, LLC	)	
<input checked="" type="checkbox"/> USA Capital First Trust Deed Fund, LLC	)	
<input type="checkbox"/> USA Securities, LLC	)	

1 I. INTRODUCTION

2 As the Court knows, Debtor USA Commercial Mortgage Company was engaged in the business  
3 of originating and managing mortgage loans. Money was received from investors known as Direct  
4 Lenders in exchange for fractionated beneficial interests in notes secured by recorded trust deeds. The  
5 interest of the Direct Lenders appear of record in the various states and counties in which those trust  
6 deeds are recorded. Although the Debtor in Possession has not yet assumed the Loan Servicing  
7 Agreements, it has continued to service the loans, distribute funds to Direct Lenders and retain servicing  
8 fees, under the authority of a limited “Order (A) Granting Debtors’ Motion to Distribute Funds” entered  
9 August 24, 2006 (Docket No. 1184) (the “Distribution Order”).<sup>1</sup>

10 Beginning in September, 2006, Debt Acquisition Company of America V (DACA) has acquired  
11 the interests of about 50 direct lenders in loans managed by the Debtor. In connection with each  
12 purchase, the Direct Lender executed a written assignment which was recorded in the county in which  
13 the Direct Lender’s interest in the deed of trust appeared of record. Promptly after purchasing each such  
14 Direct Lender interest, DACA has notified the Debtor of the assignment in writing.

15 Until this Motion, the Debtor has not attempted to obtain an injunction or order restricting the  
16 right creditors to assign their claims (or, in the case of the Direct Lenders, to assign their fractional  
17 beneficial interests in loans under management by the Debtor in Possession). Now, after DACA has  
18 purchased 50 Direct Lender claims, the Debtor in Possession has filed a motion which seeks to have the  
19 Court rewrite the provisions of the Loan Servicing Agreements, restrict the Direct Lenders’ right to sell  
20 their trust deed interests, and retroactively penalize the assignees of Direct Lender interests.

21 II. STATEMENT OF THE CASE

22 According to declarations filed in connection with the Distribution Motion, management of the  
23 Debtor in Possession has prepared an accounting for each loan in which Direct Investors participated  
24 and has determined whether there were funds “due to” or “due from” each Direct Investor as to each  
25 loan as of the Petition Date. An amount which was “due to” a Direct Lender would arise from  
26 payment(s) received by the Debtor as loan servicer pre-petition which were not remitted to the Direct  
27

28 <sup>1</sup> The Debtor’s Motion to Distribute Funds and to Grant Ordinary Course Releases and Distribute Proceeds (Docket No. 847) is referred to in this brief as the “Distribution Motion.”

1 Lender. An amount which was “due from” a Direct Lender would arise from payment(s) which were  
 2 made by the Debtor to the Direct Lender in spite of the fact that no payment had been received from  
 3 the Borrower. These payments have been referred to in papers filed in this case as “Prepaid Interest.”

4 A. MUTUALITY, NETTING AND RECOUPMENT ISSUES

5 In the Distribution Motion, the Debtor in Possession made two assertions concerning the  
 6 recovery of so-called “Prepaid Interest” (i.e., sums “due from” a Direct Lender). First, it was argued  
 7 that the Debtor in Possession ought to be able to recover “Prepaid Interest” by offsetting amounts which  
 8 were “due from” the Direct Lender on the petition date against sums which the Debtor in Possession  
 9 collected on account of that same loan after the petition date. The Distribution Motion recognizes  
 10 obliquely, but does not state directly, that this mode of recovery of Prepaid Interest is not an offset  
 11 which is authorized under 11 U.S.C. § 553(a), because the debts involved did not arise mutually pre-  
 12 petition. While the “due from” debt existed *pre-petition*, the claimed opportunity to offset would only  
 13 arise, if and when the Debtor in Possession collects loan proceeds from the borrower *post-petition*.<sup>2</sup>

14 The Distribution Motion sought to get around the mutuality requirement by invoking a  
 15 recognized equitable exception: the doctrine of recoupment. The Distribution Motion argued that the  
 16 Debtor in Possession could recover Prepaid Interest by offset against post-petition collections because  
 17 recoupment applies. The Distribution Motion asserted that recoupment should apply not merely on a  
 18 loan by loan basis but to all loans serviced by the Debtor in Possession in which a particular Direct  
 19 Lender was involved.

20 The Debtor in Possession was authorized to engage in this broad netting (i.e., on a lender-by-  
 21 lender basis rather than on a loan-by-loan basis) under the Distribution Order. However, the  
 22 Distribution Order recites that it is “preliminary in nature” and without prejudice to a challenge by any  
 23 party as to the right of the Debtor in Possession “to net all amounts that may be owed to or from a Direct  
 24 Lender.” (Distribution Order p.3 ln. 17 - p. 4 ln. 7.) A further hearing on the Distribution Motion has  
 25 been scheduled for January 3, 2006, a date after the scheduled plan confirmation hearing.

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27  
 28 <sup>2</sup> The Distribution Motion assumes (but this Court never decided) that payments collected  
 in trust by the Debtor in Possession as a loan servicer constitute a “debt” owing to the Direct Lender and  
 subject to offset. For a contrary view, See, *In re Bourne*, 262 B.R. 745 (Bankr. E.D. Tenn. 2002).

1 B. ASSIGNABILITY OF THE DIRECT LENDER INTERESTS

2 As stated in the Distribution Motion, the fee called for under the various Loan Servicing  
3 Agreements was either 1% or 3%. DACA has acquired beneficial interests in loans which are serviced  
4 under both 1% and 3% agreements.

5 The Loan Servicing Agreements between the Debtor and Direct Lenders<sup>3</sup> states in Article 5:

6 Should Lender desire to sell all or any part of its interest in the note and  
7 deed of trust, USA will assist Lender in finding potential buyers and  
8 completing the necessary documentation for the transaction. A fee of 5%  
9 of the remaining balance of Lender's undivided interest in the note  
amount will be deducted from the selling price and paid to USA on all  
such assignments for which USA locates the Assignee.

10 The above-quoted provision indicates that the parties intended that the interest of the Direct  
11 Lender in any loan would be freely assignable, and that only if the Debtor located an assignee would  
12 it be entitled to receive a 5% assignment fee. This would make sense, because 5% would substantially  
13 exceed any administrative costs incurred by the Debtor, and is more in the nature of a commission than  
14 an administrative fee.

15 Article 16 of the Loan Servicing Agreement also generally provides:

16 16. Successors and Assigns. This Agreement shall be binding  
17 upon and shall inure to the benefit of the parties' respective successors  
and assigns.

18 Under this provision, the rights of either party under the Loan Servicing Agreement are freely  
19 assignable. The Debtor in Possession is in the process of taking advantage of the assignable nature of  
20 these agreements by conducting an auction under which it intends to sell its rights under the Loan  
21 Servicing Agreements to the highest bidder.

22 The free transferability of the loans purchased were an important part of the bargain with each  
23 Direct Lender. Many of these loans were sold to people whose investments were retirement savings,  
24 or who otherwise need liquidity in their investments. The Debtor promised under the Loan Servicing  
25 Agreement to assist the Direct Lenders in finding a new investor to buy their interest if they wished.  
26 Unfortunately, the Debtor in Possession is presumably not in a position to keep this promise now.

27  
28 <sup>3</sup> A copy of the standard form Loan Servicing Agreement is attached as Exhibit B to the  
Distribution Motion.

1        There is no reason for the Debtor in Possession, or this Court, to assume that it is in the interest  
 2 of the Direct Lenders to discourage parties like DACA from purchasing interests in these loans. The  
 3 Direct Lenders who have chosen to sell their interests to DACA have recovered from 70% to 88% of  
 4 their investments to meet immediate cash needs by selling their interests to DACA, mitigating the risk  
 5 and damage which many of these investors may have incurred by being placed in inappropriate, illiquid  
 6 investments in the first place by the Debtor in its role as a mortgage loan broker. The Official  
 7 Committee of Holders of Executory Contract Rights through USA Commercial Mortgage Company (the  
 8 “Direct Lenders Committee”) has filed an opposition to the Motion which emphasizes the importance  
 9 of these transfer rights to the Direct Lenders.<sup>4</sup>

#### 10        C.        DACA’S INVOLVMENT

11        DACA did not begin acquiring the interests of Direct Lenders in particular loans until  
 12 September, after the entry of the Distribution Order. DACA has so far acquired only interests in  
 13 particular loans and has not acquired the entire portfolio of any Direct Lender. In purchasing these  
 14 interests, DACA was aware of the Debtor’s position that “due from” amounts could be collected from  
 15 any Direct Lender by recoupment against any payment due to that Direct Lender on any loan. Under  
 16 the Distribution Order, a Direct Lender with a portfolio consisting of several loans, who wanted to  
 17 assign an interest in one loan, faced the problem that the purchaser of that particular loan might be  
 18 burdened with an offset of an amount which related to other loans not sold.

19        To solve this problem, DACA obtained the agreement of each Direct Lender seller to place a  
 20 portion of the purchase price for the loan with an independent escrow. If Prepaid Interest were later  
 21 collected by offset against the loan purchased by DACA, then the escrow amount would revert to DACA  
 22 in the amount of the offset. If the Prepaid interest were collected by offset against other loans not sold  
 23 to DACA, the escrow funds would be released in that amount to the Direct Lender. It is for this reason  
 24 that DACA is unaffected by the position of the Debtor in Possession that loans should be netted on a  
 25 lender-by-lender basis and not a loan-by-loan basis.

26        ///

27 \_\_\_\_\_  
 28        <sup>4</sup>        The Direct Lender Committee’s opposition (Docket No. 1926) briefs the issue of the  
 assignability of interests by the Direct Lender. The authority cited in that brief further supports DACA’s  
 position that the interests are freely assignable, and is not repeated in this Memorandum.

To summarize, the sale of Direct Lender interests in these loans meets a legitimate need of those people who require liquidity in their investment and who could not, since the beginning of this case, call upon the Debtor in Possession to perform the function of finding a new investors as it was required to do under the Loan Servicing Agreement. DACA has offered fair prices for these loans. DACA has carefully taken into account the relief requested in the Distribution Motion and has tailored its purchase agreements to avoid conflict with the desire of the Debtor in Possession to use lender-by-lender netting. DACA has engaged in no misconduct or overreaching. There is no reason for the Debtor in Possession to penalize the Direct Lenders, or DACA, by seeking retroactive relief which seems to have as its aim a restraint on alienation of the loans.

### III. DACA’S POSITION ON THE RELIEF REQUESTED IN THE INSTANT MOTION

The Motion requests that the Court approve five “rules and procedures” relating to the assignment of Direct Lender interests. These “rules and procedures” refer to DACA and other purchasers as “Third Party Investors” and are quoted below in italics:

#### A. THE “PERMANENT OFFSET” ELECTION

*USACM shall not be required to recognize any assignments of an interest in a Serviced Loan by a Direct Lender to a Third-Party Investor unless and until the Third Party Investor: (a) either (i) purchases all of the Direct Lender’s interests in all of the Serviced Loans held by that Direct Lender; or (ii) agrees that, in USACM’s sole and absolute discretion, any or all of the “due from” amounts on account of Prepaid Interest that are associated with any other loans held by the Direct Lender, as indicated on USACM’s books and records, will be transferred along with the assignment of the particular loan interest in question to the Third-Party Investor, and will be deemed to effect a permanent offset against the balance owed to the Third-Party Investor on account of the assigned loan interest; and (b) agrees that the investment is subject to any and all holdbacks established by Court order in these cases that relate or may relate to the loan interest at issue.*

As explained above, because of the escrow arrangement negotiated between DACA and the Direct Lenders, the economic interests of DACA will not be injured if the Debtor in Possession is allowed by the Court to recover Prepaid Interest on a “lender by lender” basis. DACA interprets the Motion as requesting that the Debtor in Possession be allowed to make an election at the time that it is notified of the transfer, that all of the “due from” amounts on account of Prepaid Interest” will be offset only against future payments on the transferred loan. If so: (i) this election should only apply to offsets

1 which have not already been made by the Debtor in Possession against other loans, since these offsets  
 2 and balances were relied upon by the parties in connection with the assignment; (ii) DACA should be  
 3 notified of the election within a reasonable time.

4 B. THE "EFFECTIVE DATE"

5  
 6 *1.2 The "Effective Date" of any assignment that meets the criteria set*  
 7 *forth in Section 1.1 above shall be the first day of the month following the*  
 8 *date on which the Third-Party Investor provides a copy of the assignment*  
 9 *as recorded in the real property records relating to the loan in question*  
 10 *to USACM and pays USACM the fee set forth below in Section 1.5.*

11 DACA has no objection to establishment of a "record date" for purposes of the assignment, in  
 12 order to insure that the Debtor in Possession is not exposed to liability for inadvertently making a  
 13 distribution after receiving notification of a transfer. However, DACA believes that the proposal of the  
 14 Debtor in Possession, to make the Effective Date be the first day of the month following receipt of  
 15 notification, and applying the Effective Date to funds received at any time during that preceding month,  
 16 will create too long a period of uncertainty as to who payments are going to and in what amount.  
 17 Presently, DACA is able to offer and make payment to Direct Lender for its interest within five days  
 18 of executing an assignment. Under the proposal made by the Debtor in Possession, that date would  
 19 could be extended to in excess of 30 days. DACA believes that a more reasonable solution would make  
 20 the assignment effective five business days after receipt by the Debtor in Possession. An order  
 21 establishing the Effective Date should also make clear that all funds which were not distributed to the  
 22 Direct Lender before the Effective Date should be distributed to the transferee on or after the Effective  
 23 Date.

24 DACA also believes that the receipt of a copy of an executed assignment should be sufficient  
 25 for a loan servicer, particularly since the assignment must be acknowledged before a notary to be in  
 26 recordable form. There is no purpose served by requiring a conformed copy of the assignment bearing  
 27 a recorder's stamp. There may be significant delays in obtaining such conformed copies from the  
 28 various counties, and these delays could straddle the first of a month.

Finally, DACA has not provided conformed recorded copies of assignments as to past  
 transactions, in part because it was not notified that this would be a requirement. The order approving



these procedures should specify that this particular rule is not retroactive in its application in cases where the Debtor in Possession has already received a non-conformed copy of the assignment.

### C. THE NEW LOAN SERVICING AGREEMENT

*1.3 Each Third-Party Investor shall be required to execute a standard USACM Loan Servicing Agreement containing a 3 % loan servicing fee provision ("LSA").*

This proposed "rule and procedure" is overreaching and an unauthorized restraint on alienation of the Direct Lender's interest in the loan and Loan Servicing Agreement. As explained above, the Loan Servicing Agreement provides that it inures to the benefit of the parties' successors and assigns. There is no legal basis to require that the servicing fee provided for under the Agreement should triple as the result of an assignment.

### D. LIMITATIONS ON DISTRIBUTIONS

*1.4 USACM shall not be required to distribute to a Third-Party Investor any loan payments received by USACM (as servicer) during any period prior to the Effective Date (as defined above). USACM may distribute such payments to the Direct Lender as indicated on USACM's books and records prior to the Effective Date in accordance with the Holdbacks and Distributions Orders. Further, USACM shall not be required to distribute any payment to a Third-Party Investor until the executed LSA is provided to USACM.*

As explained above, DACA has no objection to an Effective Date procedure, but believes that a notice period of five business days should be sufficient. DACA should not be required to provide conformed copies of assignments bearing a recorder's stamp. Finally, application of the "Effective Date" procedure should not be retroactive where the Debtor in Possession has already been sufficiently notified of an assignment. However, there is no legal basis for requiring DACA to sign a new Loan Servicing Agreement.

### E. PROCESSING FEES

*1.5 USACM's fee for processing transfers where the Third Party Investor has prepared and recorded the Assignment shall be \$100 per loan. If USACM prepares the recording documents, an additional \$250 per loan will be assessed. Neither USACM nor any subsequent loan servicing provider shall be liable for any defect or error in the recording documents other than for gross negligence or intentional misconduct.*



1        There is no legal basis for the Court to rewrite the Loan Servicing Agreements to provide for fees  
 2 in addition to those agreed to by the Debtor and the Direct Lender. Article 5 of the Loan Servicing  
 3 Agreement, quoted above, states in part that “a fee of 5% of the remaining balance of Lender's undivided  
 4 interest in the note amount will be deducted from the selling price and paid to USA *on all such*  
 5 *assignments for which USA locates the Assignee.* [italics added].” The parties specifically addressed  
 6 the issue of fees in the case of an assignment of the Direct Lender’s beneficial interest in the loan, and  
 7 they provided for a fee only in the case in which the Debtor located the assignee at the request of the  
 8 Direct Lender.

9        IV.     THIS COURT HAS NO POWER TO CHANGE THE TERMS  
 10               OF THE LOAN SERVICING AGREEMENTS

11        The Motion is expressly based on the Bankruptcy Court’s general equitable powers granted 11  
 12 U.S.C. § 105(a). While section 105 grants broad power to a court to implement the Bankruptcy Code,  
 13 it is not a blank check to enter any order which a bankruptcy court determines to be “fair” or of benefit  
 14 to a debtor. Although the bankruptcy court “‘is a court of equity, it is not free to adjust the legally valid  
 15 claim of an innocent party who asserts the claim in good faith merely because the court perceives that  
 16 the result is inequitable.’ DeNatale & Abram, The Doctrine of Equitable Subordination as Applied to  
 17 Nonmanagement Creditors, 40 Bus. Law. 417, 428 (1985).” *U.S. v Noland*, 517 U.S. 535, 538, 116  
 18 S.Ct. 1524, 134 L.Ed.2d 748 (1996). “Bankruptcy courts are not authorized in the name of equity to  
 19 make wholesale substitution of underlying law controlling the validity of creditors' entitlements, but are  
 20 limited to what the Bankruptcy Code itself provides.” *Raleigh v. Illinois Dept. of Revenue*, 530 U.S.  
 21 15, 24-25, 120 S.Ct. 1951, 147 L.Ed.2d 13 (2000). See generally, Ahart, “The Limited Scope of Implied  
 22 Powers of a Bankruptcy Judge: A Statutory Court of Bankruptcy, Not a Court of Equity,” 79 Am. Bankr.  
 23 L.J. 1 (2005).

24        The power of the Court to alter the entitlements of the Direct Lenders is further limited due to  
 25 the fact that the Direct Lenders’ interest in these loans, and the payments received by the Debtors in its  
 26 capacity as loan servicer, are not property of the bankruptcy estate. The fact that loans merely serviced  
 27 by the Debtor are not property of the estate is expressly recognized by 11 U.S.C. § 541(d), which  
 28

1 provides:

2 Property in which the debtor holds, as of the commencement of the case,  
3 only legal title and not an equitable interest, such as a mortgage secured  
4 by real property, or an interest in such a mortgage, sold by the debtor but  
5 as to which the debtor retains legal title to service or supervise the  
6 servicing of such mortgage or interest, becomes property of the estate  
under subsection (a)(1) or (2) of this section only to the extent of the  
debtor's legal title to such property, but not to the extent of any equitable  
interest in such property that the debtor does not hold.

7 See, *In re LiTenda Mortg. Corp.*, 246 B.R. 185 (Bankr. D. N.J. 1999) aff'd, 276 F.3d 578 (3d Cir.2001)  
8 (holding that mortgage loans which chapter 7 debtor sold pre-petition were not property of the estate  
9 even though debtor retained servicing rights).

# 10 V. CONCLUSION

11 DACA recognizes the interest of the bankruptcy estate in adopting rules and procedures as to  
12 the transfer of Direct Lender interests which will avoid conflict and ambiguity. An example of such a  
13 rule is the "Effective Date" procedure, modified in some respects as explained above.

14 However, requiring DACA as assignee to enter into substitute loan servicing agreements with  
15 provisions for higher servicing fees and new administrative fees goes beyond practical needs and  
16 amounts to nothing more than a "wish list" request by the Debtor in Possession. Granting this relief  
17 would restrict the alienability of these interests at the expense of the Direct Lenders.

18 DACA requests that the Court's order on the Motion provide:

19 1 That if an "Effective Date" for assignments is imposed: (i) the Effective Date is five business  
20 days after notification of the assignment; (ii) that all distributions not made to the Direct Lender  
21 prior to the assignment date must be made to the assignee; (iii) that transferees may produce  
22 executed copies of the assignment without the need for a recorder stamp; and (iv) that the  
23 assignments as to which the Debtor was notified previously are effective, i.e., the Effective Date  
24 shall not be applied retroactively.

25 2 That the Debtor may elect to offset all amounts "due from" the Direct Lender against future  
26 payments collected against a transferred loan, by giving written notice of the election to the  
27 transferee within 30 days after the Effective Date.  
28

1 3 That, consistent with the Court's order on the Distribution Motion, the right of the Debtor in  
2 Possession to recoup against future payments on any loan has not yet been determined by the  
3 Court and that the parties' claims rights and defenses as to the recoupment issue are preserved.

4 4 That the Motion is denied in all other respects.

5 ///

7 DATE: December 5, 2006

KIRBY & McGUINN, A P.C.

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By: /s/ Dean T. Kirby, Jr  
Dean T. Kirby, Jr. Attorneys for  
Debt Acquisition Company of America V

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